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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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I am sometimes accused of presenting a bullish case for the market and then tempering my arguments with a smattering of caution, a practice commonly called "hedging" or "fence-straddling". But I submit that there are few times when an overwhelmingly bullish or bearish stand is justified. These occasions do arise, however, and they are usually seen immediately after a bull or bear signal or directly following an extended correction of the primary swing (secondary reaction). Such spots are invariably greeted with great skepticism by Wall Street and the public, and this disbelief merely fortifies the "contrary opinion" of the Dow Theorist.

Any advisor who can now assume a dogmatic stand regarding the intermediate trend of the market is either gambling with his clients' money, playing the part of a prophet, or simply ignoring the lessons of history. I have attempted in Letters written during the last few months to outline my reasons for believing that the primary trend is up and that this bull market has further to go. I have discussed the lack of climactic volume (Letters 54, 60, 64, 65), the enormous cash reserves on the sidelines (44, 60, 66), the still impressive short interest (57, 64), the absence of an expected rail confirmation over the 1956 highs (46, 51, 63), and the bullish timing element in the price movements; i.e., bull market declines tend to be rapid whereas bull market advances are usually slow and plodding (49, 69).

Conversely, recent Letters have suggested that subscribers watch for danger signals in the price movements which might warn of a reaction. Readers were also advised to show some respect for a 230 point primary swing which has advanced the D-J industrials 55% since late 1957 without the appearance of anything resembling a secondary correction.

POLICY. My policy has been to advise long-term investors to hold securities for as long as we can be reasonably certain that the primary trend is up. Traders and short-term holders must, on the other hand, pay more attention to the minor and secondary movements. Yet it should be remembered that the minor movements provide the first indications of secondary reversals, and the secondary swings allow us to judge the position of the all-important primary trend. For this reason, a running account of the price movements (together with the technical condition of the market) is presented in these Letters, and readers are encouraged to follow the logic behind our classification of the trend.

GLOBAL BULL MARKET. All primary and most secondary movements are international in scope. It is therefore not surprising to read the record highs are being set in stock exchanges all over the free world, from London to Zurich, from Toronto to Amsterdam. Last week, in fact, it was announced that stock indexes in West Germany had advanced an incredible 10% within the space of five trading days. That same week the Tokyo stock exchange, having witnessed record-breaking volume and prices, saw fit to warn the public about the dangers of stock speculation. The unreasoning frenzy which has accompanied most great "popular delusions" is now beginning to appear, and this type of excitement could well be the prelude to our predicted 6-8 million share days on the N.Y. Stock Exchange.

Following great stock distributions, the nation's securities always come home to Wall Street to roost. In May, 1927, Hamilton wrote in Barron's calling attention to the widespread character of the stock buying at that time. He warned that if the public confidenc were to be unexpectedly shaken, Wall Street might be the recipient of a quantity of stock which it was not equipped to handle. In this event, wrote Hamilton, the resultant break could be of more than ordinary proportions.

The New York Stock Exchange has recently waxed poetic over the fact that 12 1/2 million people now hold a share in America. While I do not wish to be unpatriotic, I am sorry to say that the phenomonon of millions of Americans engaged in a business about which they know nothing strikes me as rather ominous.

TECHNICAL INDICATORS. The yield on the D-J industrials is now 3.01%, lowest in history and below the 3.1% of 1929. Even allowing for dividend increases in the near future, this tiny yield implies that most common stocks have strayed far from the bargain counter.

Barron's Low-Priced Stock Index hit 304.5 last week, a new high. This index was 173 at the peak of the 1946 bull market; it dropped to 50 in 1949 when this bull market began. Last week's figure indicates that the "cats-and-dogs" have been making spectacular advances in their traditional third phase visit to outer space. We will watch this index carefully, however, for history shows that the low-priced stocks have a habit of topping out before the D-J averages. (see special study on Low-Priced stocks).

Odd-lot transactions have remained on the buy side all year (which is normal), but over the last few months there has been no consistant surge towards the buying side even when prices worked higher. For this reason we can say that the public, as measured by this study, has shown no inclination to rampant bullishness. This, of course, is a plus factor in the market.

MARKET. Subsequent to the X pts., both averages rallied, then turned down to test the lows as volume dropped dramatically. Because of the complete absence of selling pressure on the test of the X lows, I termed this area (621-5 on the industrials, 161-3 on the rails) a "buy-spot". Letter 70 pointed to the well-defined upward zig-zag (X-Y-Z-A), and I observed that "such formations usually hold bullish connotations". Since the buy spot (Z), industrials have advanced 12 out of 13 days for a total of 38 points. In so doing they have climbed well above their previous high at W. Rails have advanced 8 points during the same period, and although moving "in gear" with industrials, they have not quite hurdled their own W high. Both indicators must better previous high points if a bullish trend is to be reaffirmed, but the Dow Theory places no time limit on the confirmation principle. A persistent refusal of the rails to better the W (169.67) high, however, should be viewed with suspicion. Conversely, a rail confirmation could inject new excitement into the current advance. Volume on the July 2 and 6 rallies picked up as prices advanced, and significantly, these two days registered the highest volume on the upside since mid-May.

Every movement in the averages is subject to a 1/3 to 2/3 retracement, and as a rule, the steeper the climb the more violent the correction. The recent rally (Z-A) has been sharp and rapid. For this reason it would be normal to have an equally sharp decline correcting 1/3 to 2/3 of the Z-A advance. The general pattern for all 1959, in fact, has run very much as follows: (1) - a sharp rally, (2) - a violent decline, (3) - a period of annoying dullness. All of this has been rather hard on the nerves of the average investor.

I might add that most secondaries start in or just after periods of relatively high volume. If a secondary is to correct the advance since October, 1957, I believe it will begin in a period of high volume, perhaps higher than anything seen so far this year. For this reason many Dow Theorists make purchases during the dullness of a buy-spot and take

profits on the ensuing advance when both volume and excitement are at a high (or as Dow wrote, "when the bull chorus is loudest").

STOCKS. With our expected rail confirmation (over the 1956 high) somewhere ahead, the following appear to be in a position to outperform the group: Pennsylvania, New York Central, Baltimore & Ohio, Atchison, Topeka & Santa Fe (all previously recommended). Chemicals recommended before but still in strong upward trends are Olin Mathieson, Monsanto, Heyden-Newport. United Airlines is outstanding in a group which may be completing a reaction of its own. Lowenstein is a textile stock which has been outperforming its own relatively strong group, and this stock recently broke out for a new high for the year. The building stocks have moved over to the weak side of the market (with oils and aircraft) and I would avoid the gypsums, the plywoods, and even blue-chip Johns-Manville.

NOTICES. Some months ago I began a series on bull market third phases. Because we are now in a great third phase, I felt that it was particularly important for readers to understand the dynamics of a bull market top. In an article for BARRON'S which is tentatively scheduled for July 13, I have told the story of the 1929, 1937, and 1946 tops. I believe that readers of these Letters will find this article well worth studying.

Charts of the D-J industrial and rail averages (daily) with volume, from 1897 to the present have recently been published by Traders Research, Inc., Suite 375, St. Louis 1, Missouri. I have always found the charted history of the averages to be an indispensable aid in studying the price movements under the Dow Theory.

(Written July 6, after the close)